EXPECT**FOCUS**®

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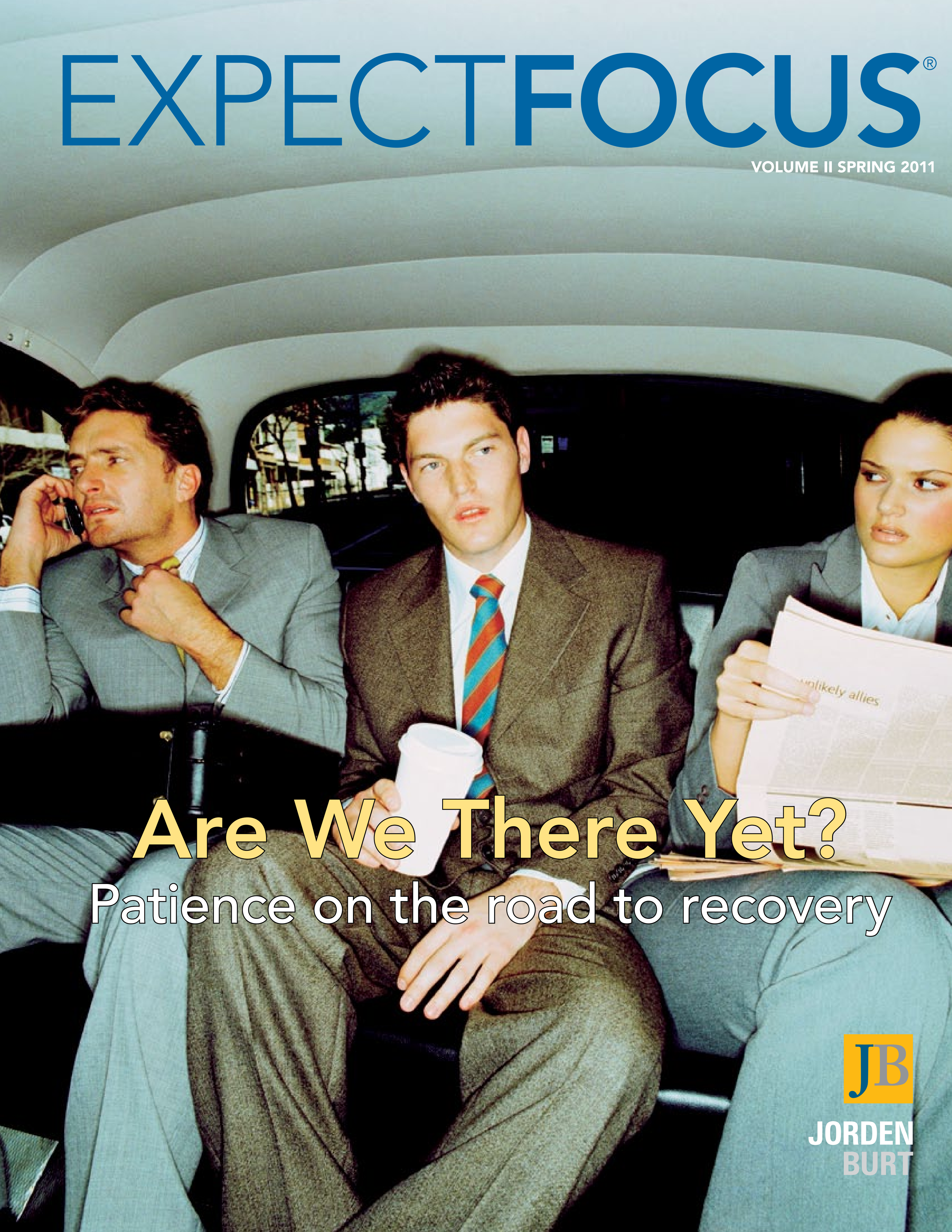

Are We There Yet?

Patience on the road to recovery

JB

JORDEN BURT

EXPECT**FOCUS**® is a quarterly review of developments in the insurance and financial services industry, provided on a complimentary basis to clients and friends of Jorden Burt LLP.

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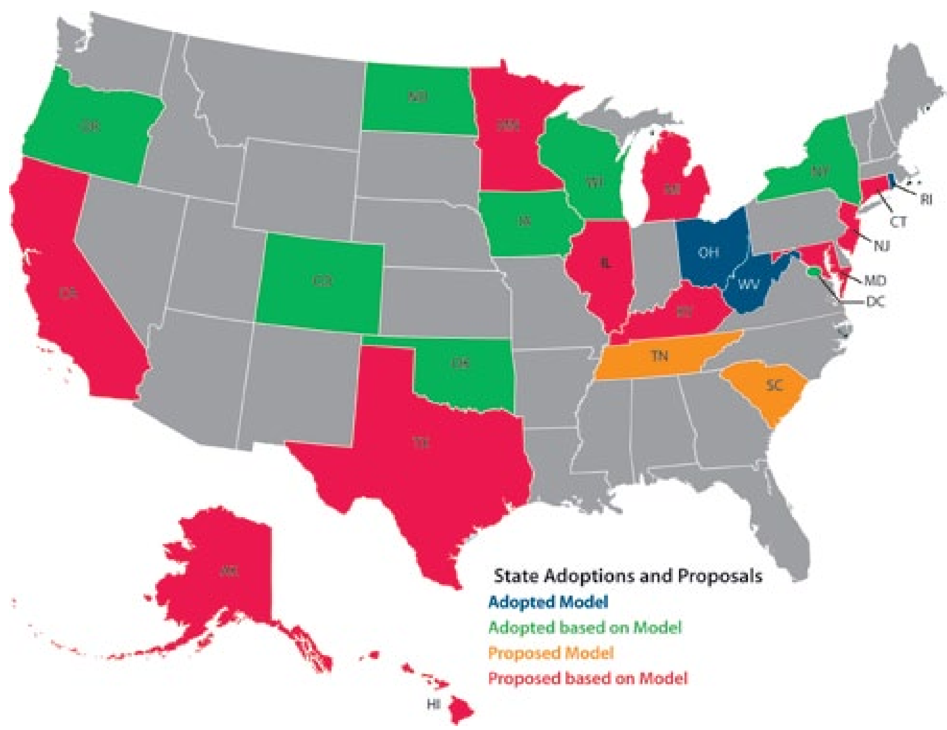
INTHE**SPOTLIGHT**

Suitability Wildfire

BY ANN BLACK & SARAH JARVIS

Adoption of the 2010 NAIC Suitability Model (the Model) is catching on. As of May 6, 2011, eleven states have adopted the Model, or provisions substantially based on the Model, and another thirteen states have Model-based provisions pending. Some states are expressly adopting the Model in order to be eligible for the grants available under Dodd-Frank Act Section 989A. In addition, others may be adopting the model as a result of the National Conference of Insurance Legislators' support for uniform adoption of the Model.

The following states have adopted or proposed suitability provisions that are based on the 2010 Suitability Model.



Notable differences from the Model include: (i) Colorado – mandates insurers satisfy the training verification responsibility by obtaining certain certificates or reports, (ii) California – mandates an eight-hour one-time producer annuity training course and four hours training every two years, and does not grant reciprocity for similar training requirements of another state, (iii) New York – does not contain a FINRA safe harbor, (iv) Wisconsin – requires certain facts in a transaction "to be true," rather than allowing there to be a "reasonable basis to believe" that those facts exist, (v) Alaska – requires that consumers received the required annuity disclosure document and buyer's guide, (vi) Oregon, Alaska, Maryland, Michigan, Minnesota and North Dakota – do not contain language reducing penalties for insurers who take corrective action or for whom there is no pattern or practice, and (vii) New Jersey – requires the suitability information be signed by and given to the consumer, and consumer notice of the regulatory oversight of the sale.

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Guaranteed Deferred Annuities: Uncertainties Persist

BY STEVEN KASS & JOAN BOROS

A successful entrepreneurial friend regularly recites this mantra: the most brilliant idea is only good if it is launched at the right time. An article published in *Expect Focus*, Vol. IV Fall 2008 speculated that the convergence of the concerns of the numerous aging "boomers" over outliving their assets with anticipated continuing uncertainties and volatility of the markets would create the Right Time for Guaranteed Deferred Annuities (GDAs). Guarantees would take on new meaning, and GDAs would radiate brilliance. Despite favorable signals from the IRS and continued fertile conditions, however, GDAs' time has not yet arrived.

Since our last article, the IRS has issued a series of private letter rulings (PLRs) favorably resolving most of the significant tax issues regarding GDAs, including a holding that a GDA issued by an insurer that guarantees the lifetime income stream if the investment fund is depleted will be considered an annuity for income tax purposes by the IRS and that payments under the contract will be treated as "amounts received as an annuity." Although PLRs can only be relied upon by the taxpayer that obtains the PLR, they are useful in ascertaining the views of the IRS.

Despite this and other encouraging news, regulatory and pricing uncertainties persist. One rather large cloud appeared on June 25, 2009 when the New York State Insurance Department issued an opinion stating that contracts it was then reviewing came within the definition of financial guaranty insurance "because [they] purport[ed] to provide indemnification for 'financial loss' resulting from 'changes in the value of specific assets[,]'" and were an impermissible form of financial guaranty insurance under New York's insurance law. This is significant because other states are currently considering adopting variations on New York's position.

The potential migration of the New York position dwarfs the favorable PLRs and the SEC's developments. It also currently pre-empts the pricing issue, which remains unchanged – the volatility and uncertainty of the markets that should drive boomers to GDAs makes it difficult for insurers to cover the costs of their hedging transactions, and the potential strain of their reserving requirements, while pricing the product at saleable levels. One valuable uncertainty: it is not clear that GDAs' time has passed.

In business, timing is everything

Mark Your Calendars

Managing Partner, **James Jorden** is co-leading the new Litigation Track of the Insured Retirement Institute's Government, Legal & Regulatory Conference, June 26-28, 2011 in Washington, DC. The Litigation Track will cover topics including Litigating Annuity Class Actions, Supreme Court Round-Up, Developments and Trends in Significant Life Insurance, Annuity and Retirement Plan Litigation, and effective Class Action Settlement Strategies. For more information visit *www.IRIConferences.org.*

Monitoring Calls to Settlement Administrator OK, says Court

BY JACOB HATHORN

In a certified nationwide class action, defense counsel's passive monitoring of telephone conversations between a class administrator and potential class members neither taints the neutrality of the class notice process nor invades the attorney-client privilege.

Following certification of a nationwide class and approval of the class notice in *In re: National Western Life Insurance Deferred Annuities Litigation*, the Southern District of California appointed an impartial third-party class administrator to disseminate the class notice to class members, and to establish a website and call center through which potential class members could obtain documents and additional information about the claims certified by the court. Class counsel had unilaterally selected the administrator, and did not reach any agreement with counsel for National Western regarding the creation of a script to answer common inquiries that could be anticipated from potential class members.

Fly on the wall is no fly in the ointment

Counsel for National Western requested a visit to the administrator's call center to monitor some calls from potential class members in order to ensure that the notice process was fair, neutral, and unbiased, and that accurate information was being provided. Class counsel vehemently objected, arguing that such monitoring would invade the attorney-client privilege, and create a "chilling effect that could deter class member communications and participation." National Western sought an order to allow its counsel to monitor incoming phone calls made by potential class members to the class administrator.

Reviewing National Western's application, **the court noted that defense counsel would be a passive monitor rather than an active participant**, and disagreed with class counsel's argument that issuance of the requested order would jeopardize the neutrality of the class notice process. The court also rejected class counsel's attempt to characterize the administrator as a paid agent retained by class counsel to act as a conduit for privileged communications with class members. Although inclined to grant defense counsel's request, the court nevertheless devised an alternate solution whereby recorded calls would be made available to both sides, which enabled defendant's counsel to monitor while simultaneously alleviating Plaintiffs' concerns, "no matter how unfounded and poorly supported."

FAA Trumps State Prohibitions Against Class Arbitration Waivers

BY BRIAN PERRYMAN

In a ruling that may surprise some, the U.S. Supreme Court has held that, because it "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress," California's judicial rule against waivers of class-wide arbitration in consumer contracts is preempted by the Federal Arbitration Act. The conventional wisdom following oral argument anticipated a contrary ruling.

The *AT&T Mobility LLC v. Concepcion* case involved a cellular telephone contract offered by AT&T. The contract provided for arbitration of all disputes, but did not permit class-wide arbitration. After the plaintiffs were charged sales tax on the retail value of phones provided free under their contract, they sued AT&T. Their suit was consolidated with a class action alleging, among other things, that AT&T engaged in false advertising by charging sales tax on "free" phones. AT&T's motion to compel arbitration was denied. Relying on the California Supreme Court's decision in *Discover Bank*, the trial court found the arbitration provision unconscionable because it disallowed class-wide proceedings. The Ninth Circuit agreed, but the Supreme Court reversed and remanded, holding a state rule against waiver of class arbitration impedes the FAA's purposes. Unless agreed to by the parties, said the Court, **class arbitration can vitiate arbitration's informality, making the process slower, more costly, and more likely to generate "procedural morass"** than would a judicial proceeding. And class arbitration increases risks to defendants. The absence of appellate review makes it more likely that errors will go uncorrected. Arbitration, the Court concluded, therefore is "poorly suited" to the higher stakes of class litigation.

Retained Asset Account Litigation Update

BY ROBIN SANDERS

The first quarter of 2011 continued to be an active time for courts adjudicating challenges to insurers' use of retained asset accounts (RAAs) to pay ERISA-governed employee benefits. In late March, the U.S. District Court for the District of Nevada entered final approval of a class settlement in *McCreary v. Aetna Life Insurance Company* and dismissed the class complaint with prejudice. In *McCreary*, the representative plaintiff had alleged that the defendant violated ERISA's fiduciary duty provisions by delaying the payment of life insurance benefits. **According to the plaintiff, the benefits were delayed as a result of their being paid through RAAs rather than through a lump sum payment, as mandated by the plan.**

Waiting too long for benefits? Plaintiffs claim RAAs create delays

Elsewhere, a Pennsylvania federal district court declined to grant an insurer's motion to dismiss an action involving RAAs. The court instead allowed the parties to conduct discovery, and noted that the defendant could reassert its substantive arguments in support of dismissal after such discovery occurred.

Scribner, Hall & Thompson, LLP

A Tax-Free Exchange of Cash-Value Life Insurance Policies Does Not Maintain "at the Time First Covered" Status for an Employee

BY SUSAN J. HOTINE

In Rev. Rul. 2011-9, 2011-12 I.R.B. 554, the IRS ruled that a life insurance policy on the life of an ex-employee as the insured, which is issued in an I.R.C. § 1035 exchange for a policy on the life of the same insured but when the insured was an employee, will not qualify for the 20-percent owners, officers, directors and employees exception from the pro rata interest disallowance rule of I.R.C. § 264(f)(1) for unborrowed policy cash values. The ruling considers and contrasts two situations. One involves an employer exchanging an old policy covering the life of an employee for a new policy covering the same employee; the other involves the same facts except that the employer exchanged the old policy after the insured had terminated his employment with the employer. In determining the amount of the pro rata interest disallowance, paragraph (4) of I.R.C. § 264(f) provides that an employer does not have to take into account any policy or contract that covers only one individual, if that individual is (*at the time first covered by the policy or contract*) a 20-percent owner, officer, director or employee. The IRS concluded that any contract received in the tax-free exchange is a new policy and that the characteristic of the insured as an "employee" does not carry over through the exchange. Accordingly, in the first situation the new policy continues to qualify for the exception because the insured was an employee when the new policy was issued (at the time of the exchange); in the second, the new policy does not, because the insured was not an employee when the new policy was issued. The IRS distinguished and did not follow Rev. Rul. 92-9, 1992-2 C.B. 43, which ruled that the "date of purchase" of an annuity contract carries over through an I.R.C. § 1035 exchange to the new annuity contract. Apparently, the "date of purchase" is not informative as to what is meant by the phrase "at the time first covered."

Progress on Key Dodd-Frank Appointments

BY ROLLIE GOSS

The Dodd-Frank Act requires the involvement of three persons with insurance expertise in its implementation:

1. The Director of the Federal Insurance Office;

2. A voting member of the Financial Stability Oversight Council (FSOC) with insurance expertise (to be appointed by the President and confirmed by the Senate); and

3. A non-voting member of the FSOC, to be a state insurance commissioner.

Michael McRaith, Director of the Illinois Division of Insurance, was recently appointed in March as Director of the Federal Insurance Office, but he will not assume his post until June 1, 2011. The NAIC appointed the current Missouri Insurance Director, John Huff, to be the nonvoting member of the FSOC, but his effectiveness has been questioned since the Treasury Department has taken the position that he represents only the State of Missouri, and has blocked him from sharing information with other insurance regulators. The third slot has yet to be filled.

The result: only modest insurance expertise is being brought to bear in the implementation of Dodd-Frank until at least June 1, 2011.

The Verdict Is In

Incontestability Provision Trumps Insurable Interest Arguments

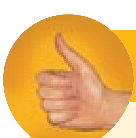
BY DAWN WILLIAMS

The Southern District of New York has upheld a jury verdict finding that the incontestability clause barred an insurer from challenging a policy's validity. The $5 million dollar life insurance policy at issue in *Settlement Funding, LLC v. AXA Equitable Life Ins. Co.* was allegedly procured through a STOLI scheme in which the insured misrepresented her net worth and her intent to transfer interest in the policy. Earlier in the litigation, the court had denied summary judgment on the issue of whether the policy was void *ab initio*, finding that **under New York law an incontestability provision would yield only to objections based on allegations of *both* lack of insurable interest and fraud**, thus, there was a question of fact as to whether the incontestability provision should bar a challenge to the policy's validity.

Challenging policy validity in New York is now more challenging

A jury answered in the affirmative after a week-long trial, awarding the assignee of the policy the $5 million proceeds with pre-judgment interest from the date of the insured's death. The court denied the defendants' Rule 50 motions, citing *Kramer v. Phoenix Life Ins. Co.*, and found that the verdict was adequately supported even though the insurer presented evidence that the insured never signed the trust, that there was no insurable interest at inception, that the trustee conspired to commit fraud, and that the policy was part of a STOLI scheme: "While it is beyond peradventure that the evidence taken as a whole raised an eyebrow or two, the problem is for the legislature and not the courts to solve."

The court also found the evidence was sufficient to support the finding that the trustee conspired to commit fraud, as AXA proved that he was complicit in an improper STOLI scheme that employed forgery and other deceptive practices to procure the policy.



Congratulations!

Jorden Burt is pleased to announce that **C. Todd Willis**, associate in the Washington office, and **Lara O'Donnell Grillo**, associate in the Miami office, have been selected as our first Pro Bono Attorneys of the Year for their extraordinary contributions to justice for the disadvantaged.

Fifth Circuit Permits Discovery in ERISA Dispute

BY W. GLENN MERTEN

The Fifth Circuit recently vacated a Louisiana district court's grant of summary judgment in favor of an ERISA health care plan, holding that the district court improperly denied the plaintiff access to information that could lead to the discovery of admissible evidence.

In *Crosby v. Louisiana Health Service and Indemnity Co.*, Louisiana Health Service and Indemnity Company (Blue Cross) denied plaintiff's claim for benefits related to a significant dental condition. After exhausting her administrative remedies, plaintiff filed suit to recover denied benefits. After Blue Cross sent plaintiff a copy of the administrative record, plaintiff sought extensive additional discovery "concerning the compilation of the administrative record, the proceedings at the administrative level, and Blue Cross's past coverage determinations" regarding similar claims. Blue Cross objected, arguing that while the requested discovery likely was relevant, it was not admissible. Relying on Fifth Circuit precedent, the magistrate denied the requested discovery, and the district court subsequently granted summary judgment in favor of Blue Cross.

On appeal, the Fifth Circuit clarified its previous decision in *Vega v. National Life Insurance Services, Inc.* **While Vega places limitations on the admission of evidence related to the merits of a coverage determination, it does not address the admissibility of evidence related to other issues that might arise in ERISA litigation.** The court saw "no reason to limit the admissibility of evidence" related to the completeness of the administrative record, compliance with ERISA's procedural regulations, and previous coverage determinations. Accordingly, the court vacated the judgment of the trial court and remanded with instructions to permit adequate discovery.

Seventh Circuit Reverses ERISA Dismissal

BY W. GLENN MERTEN

A plaintiff presents the following scenario in litigation: he needed gastric bypass surgery, waited for four months before receiving preauthorization from his insurer for the operation, then, after the surgery was completed, was informed that his claim was being denied because the surgery was excluded by his plan. Does the plaintiff have a claim against his insurer, and, if so, for what? These were, essentially, the factual allegations brought before the Eastern District of Wisconsin, and subsequently, the Seventh Circuit Court of Appeals in *Smith v. Medical Benefit Administrations Group, Inc.*

Four months after Jeffrey Smith applied for preauthorization for gastric bypass surgery, claims administrator Auxiant preauthorized the procedure. After the surgery, however, Auxiant informed Smith that his plan excludes from coverage medical services related to obesity, and denied his claim. Smith exhausted his administrative remedies and sued, asserting breach of fiduciary duty and various claims under ERISA section 502(a). The district court dismissed the complaint in its entirety, holding that: (i) Smith could not assert a claim for benefits under section 502(a)(1), because the health insurance plan does not cover gastric bypass surgery; (ii) Smith could not obtain relief under section 502(a)(2), because he was seeking compensation for his own losses, not plan losses; and (iii) neither extracontractual damages nor injunctive relief were available pursuant to section 502(a)(3)(B), because Smith sought to "modify rather than … vindicate the terms of his health insurance plan."

On appeal, the Seventh Circuit held that the complaint articulated a viable theory of liability. **In particular, Auxiant's four-month delay in providing a preauthorization decision and then preauthorizing a procedure the plan did not cover could constitute a breach of fiduciary duty.** As for the ERISA claims, however, the Court affirmed the district court's determinations with respect to sections 502(a)(1) and (2), on the grounds that the relief sought was not available. The Court also found that extracontractual remedies were not available under section 502(a)(3)(B), but held that injunctive relief that would not modify the terms of the plan was available. For example, the district court could require Auxiant to modify its preauthorization procedures to comply with applicable regulations and/or to fulfill its fiduciary duty to plan participants.

First Circuit: Refusal to Cooperate Breached Policy

BY JAMES GOODFELLOW

In October 2004, Theresa and James Miles filed a claim with Great Northern Insurance after a fire occurred at their home. While Ms. Miles held title to the property, both Mr. and Ms. Miles were named insureds on their comprehensive homeowners policy, which required them to submit to an examination under oath and to deliver documentation in the event of a loss.

A police investigation of the fire determined that was set intentionally and Mr. Miles was named as a "person of interest." After Great Northern initiated its investigation, the Mileses **refused to answer a number of interrogatories regarding their claim, did not cooperate during the required examination, and failed to provide any documentation until well after Great Northern decided to deny coverage**. In the subsequent lawsuit, the district court concluded that Mr. Miles breached the insurance policy and that his actions would be imputed to Ms. Miles.

In *Miles v. Great Northern Insurance Co.*, the First Circuit Court of Appeals affirmed on the alternative ground that the district court's factual findings made plain that Ms. Miles independently breached the policy. The court further concluded that prejudice need not be shown because Ms. Miles willfully and without excuse refused to cooperate with Great Northern's reasonable requests for information.

Claims for Reimbursement Should Be Made Before Initiation of Lawsuit

BY JONATHAN STERLING

The Ohio Supreme Court recently held that where an insured never submitted a claim for reimbursement to his auto insurer, he had no standing to sue for breach of contract for the insurer's refusal to pay. Central to the court's determination was that, at the time the insured initiated his suit against the insurer, there was no actual controversy.

In *Kincaid v. Erie Insurance Company,* plaintiff Kincaid was involved in a motor vehicle accident. He was covered by a policy issued by defendant Erie Insurance Company (Erie). After Kincaid was sued for the accident, Erie hired counsel to defend him, and the case was subsequently settled and dismissed.

Although Kincaid never made a claim under his policy for reimbursement of litigation-related expenses such as postage, travel and loss of earnings, he filed a class action complaint alleging that Erie breached its policies by denying him and others reimbursement for such expenses. It was undisputed that Erie had no notice of expenses incurred by Kincaid until it received the class action complaint. The trial court granted Erie's motion for judgment on the pleadings, concluding that since Erie was never presented with a reimbursement claim to pay or deny, Kincaid had sustained no damages and therefore lacked standing.

Although the Court of Appeals reversed the trial court, a four-justice majority of the Ohio Supreme Court held that, **lacking a refused reimbursement claim by Erie, the parties did not have adverse legal interests when Kincaid sued**, and there was no justiciable controversy.

Florida's Public Adjuster Ban Ruled Unconstitutional

BY JOHN HERRINGTON

A Florida appeals court determined that a state statute, which barred public adjusters from initiating contact with insureds for 48 hours after an event giving rise to a potential claim, restricted commercial speech in violation of the Florida Constitution under the standards of *Cent. Hudson Gas and Elec. Corp. v. Pub. Serv. Comm'n. of New York*. The determination turned on a question of statutory interpretation. The trial court had previously interpreted the statute narrowly and rejected a public adjuster's free-speech challenge. On appeal, the court reversed after concluding that the statute was not narrowly tailored to meet the State's objectives.

The dispositive issue in *Kortum v. Sink* was whether the statute banned all solicitation for 48 hours, or whether the statute prohibited only face-to-face and telephonic solicitation, while still allowing for written and email solicitations. The court determined that it was clear that **the statute prohibited all public adjuster-initiated contact, whether electronic, written or oral**. In reaching its conclusion, the First District Court of Appeal noted that the statute's plain language was all-encompassing and that the legislative history did not support a limited interpretation. The court also rejected the argument that U.S. Supreme Court precedent limiting solicitation by attorneys applied to this situation. The Florida court distinguished public adjusters from attorneys by noting that "lawyers are trained in the art of persuasion, public adjusters are not."

States Divided on Surplus Lines Approach

BY KAREN BENSON

The Dodd-Frank Act's Non-admitted and Reinsurance Reform Act (NRRA), which is to become effective July 21, 2011, prohibits any state that is not the home state of a surplus lines insurance policyholder from collecting premium taxes on that policy. The NRRA directs the states to enter into a compact or otherwise establish procedures to allocate among the states the premium taxes paid to a policyholder's home state for non-admitted insurance.

Will states be able to put together uniform procedures?

Two competing proposals have emerged. The "Surplus Lines Insurance Multistate Compliance Compact," or SLIMPACT, was created by the National Conference of Insurance Legislators and has been endorsed by the Council of State Governments and the National Conference of State Legislators. The other proposal, called the "Non-admitted Insurance Multi-State Agreement," or NIMA, was advanced by the National Association of Insurance Commissioners. NIMA is generally limited to the allocation of nonadmittted insurance premium taxes, whereas SLIMPACT takes a broader approach to the modernization of surplus lines regulation.

As of March 11, 2011, at least 21 states had proposed or adopted surplus lines insurance legislation to conform to the NRRA. Of the 21 states, ten introduced or adopted SLIMPACT or legislation authorizing the commissioner to enter into SLIMPACT; one state introduced both SLIMPACT and NIMA legislation; two states introduced or referenced NIMA; and eight states have proposed or adopted surplus lines legislation authorizing the commissioner to enter into a compact or multistate agreement without specifying either SLIMPACT or NIMA. As the state legislative sessions proceed, these numbers are likely to change, but one potential result is that a uniform compact will not be adopted by all of the states. **These developments have caused some to question the viability of the NRRA's July 21, 2011, effective date.** More information on state surplus lines developments is available on Jorden Burt's reinsurance blog at *www.ReinsuranceFocus.com.*

Treaty Tips: Prepared To Honorably Engage?

BY ANTHONY CICCHETTI

The arbitrators shall interpret this contract as an honorable engagement and not as merely a legal obligation.

"Honorable engagement" clauses like this one appear in many reinsurance agreements, especially those drafted some years ago. Given the nature of some risks, those older agreements may be the subject of dispute resolution today, or even tomorrow. In any event, whether entering dispute resolution relating to an older agreement or drafting a new agreement, **it is important to keep in mind that the honorable engagement clause confers broad discretion on the arbitrators**. The presence of this clause allows a party to argue that equity and fairness, as opposed to strict interpretation of the agreement's terms and conditions, should serve as the foundation of the arbitrators' award. Such a clause could also affect the extent to which arbitrators follow, or even consider, relevant case law, or require procedural and evidentiary formalities. In the end, the honorable engagement clause could make it even more difficult to upend an arbitration award on the basis that the arbitrators exceeded their authority.

The rules of engagement: look them up in your arbitration agreement

More Action on State Reinsurance Collateral Requirements

BY ANTHONY CICCHETTI & ROLLIE GOSS

New Jersey's governor has signed into law a new bill authorizing reduced reinsurance collateral requirements for qualifying reinsurers that meet certain financial and regulatory standards. New Jersey's intended approach appears similar to the ratings-based frameworks already in place in Florida and New York. One interesting wrinkle, however, is that New Jersey's law authorizes the commissioner, in determining required collateral, to consider "the reinsurer's or an affiliate's use of in-state professional service providers related or unrelated to the reinsurance, including, but not limited to, attorneys, accountants, managers, actuaries, brokers or intermediaries." Whether this consideration will have any real impact on collateral requirements remains to be seen. The new law and a summary thereof can be found on our blog, *www.ReinsuranceFocus.com*.

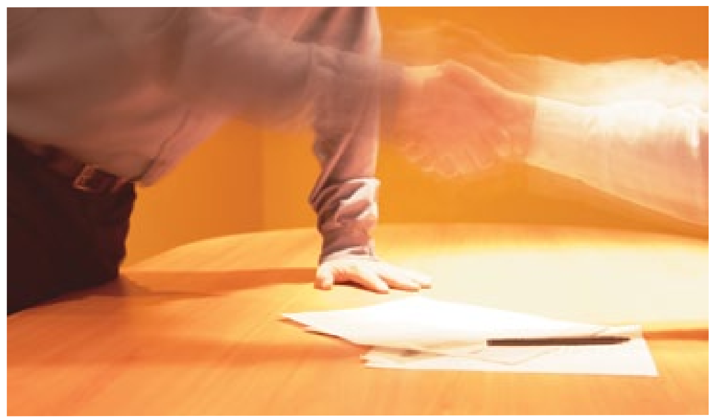
The Florida Office of Insurance Regulation has authorized three more Bermuda-based reinsurers to operate in Florida with reduced reinsurance collateral requirements. Consent Orders have been entered approving Montpelier Reinsurance Ltd., Alterra Bermuda Limited and Arch Reinsurance Limited for the program. **The addition of these companies brought to 12 the number of reinsurers authorized by Florida to operate under reduced collateral requirements.**

Meanwhile, the NAIC in late February 2011 exposed for comment proposed amendments to the Credit for Reinsurance Model Law and Credit for Reinsurance Model Regulation. Among other things, the proposed amendments incorporated the ratings-based collateral framework and other key elements of the NAIC's 2008 Reinsurance Regulatory Modernization Framework Proposal related to reinsurance collateral matters. Many industry participants submitted comments on the drafts, which were discussed at the NAIC's Spring National Meeting. The Reinsurance (E) Task Force has indicated that it intends to hold an interim meeting to further discussed the proposed revisions.

Retrocessionaire Bound by Unwritten Agreement

BY MICHAEL N. WOLGIN

When IRC Re Limited "at the 11th hour" denied the existence of a written reinsurance agreement and refused to pay its share of the liabilities arising from the underlying insurance program, Trenwick America Reinsurance sued IRC Re, its CEO, and IRC Re's affiliate responsible for managing the underlying insurance program for breach of contract, fraud, and bad faith. In *Trenwick America Reinsurance Corporation v. IRC, Inc.*, the U.S. District Court for the District of Massachusetts found that IRC Re breached an unwritten retrocessional reinsurance agreement in bad faith.



Indicia of retrocessional agreement may trump lack of written accord

The court relied on rather voluminous evidence, such as IRC Re's conduct (e.g., accepting premium payments), multiple pieces of correspondence from IRC Re's CEO revealing his understanding that an agreement existed, and testimony from other parties involved in the underlying insurance program. Among its holdings, **the court held that the "follow the fortunes" doctrine precluded IRC Re from raising defenses to the underlying liabilities**. The court found that the doctrine was customary in the reinsurance industry and was therefore applicable even in the absence of a written agreement.

While the court rejected Trenwick's fraud count, it did find that all three defendants violated the Massachusetts unfair and deceptive trade practices statute. The court reasoned that with the program's manager and the program's reinsurer "aligned on the same side" there was "little chance of resolving the claim in a timely fashion and surely without litigation" and they "did everything they could to obfuscate the issues and stall their ultimate resolution."

2011 for 12b-1?

BY GARY COHEN

Top SEC representatives are stating publicly that the SEC's Rule 12b-1 reform proposal is still on the SEC's agenda, but at least one high-ranking staff official is reported to have said privately that the Commission is not likely to act in 2011.

Recent word from Commissioner Elisse Walter is reportedly that the SEC would move with "full force" on the SEC's proposal as soon as this summer. This can be read to contradict a previous statement by a staff official that industry leaders should not expect formal Commission action until 2012.

There are two views of the situation. One view is that Commissioner Walter's statement means that the staff will move with "full force" to review some 2400 comment letters and come up with recommendations for the Commission to act on in 2012.

There are two distinct views of how the SEC might proceed

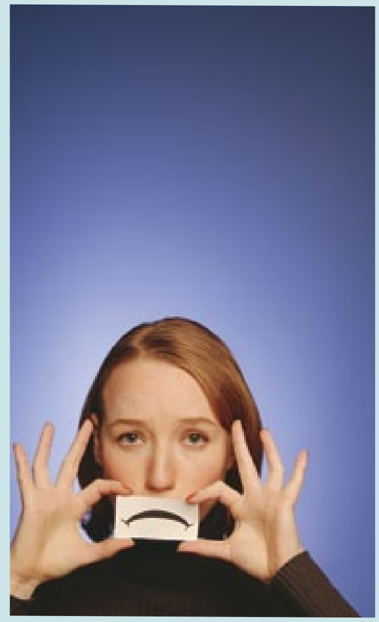
The other view is that the staff of the Division of Investment Management has the capacity now to review the comments and develop recommendations for the Commission to consider in the fall. This view is based on the fact that the Division's work implementing the Dodd-Frank Act is at a point where staff can be freed up to work on the comments.

A prominent industry economist/consultant has observed that fund sponsors are moving away from Rule 12b-1 plans with fees exceeding 25 basis points. In the end, the SEC may be achieving some of its objective without adopting its proposal.

Warmed-Over Money Market Fund Credit Rating Proposal

BY SCOTT SHINE & TOM LAUERMAN

In March 2011, the SEC proposed amendments to eliminate references to credit ratings in certain rules and forms, including Rule 2a-7 (relating to money market funds) under the Investment Company Act. The proposals respond to a requirement in the Dodd-Frank reform legislation that the SEC replace such references in its rules with other appropriate standards of creditworthiness not later than July 21, 2011.



No one's really all that happy with the proposal

Under the proposals, credit ratings would no longer be required to be used in determining which securities are permissible investments for a money market fund. The SEC has previously served up comparable proposals, including a 2008 proposal that ultimately was tabled in the face of strong industry opposition. **The language and substance of the new proposal is very similar to the 2008 proposal, and the comments on the new proposal have been similarly cool.**

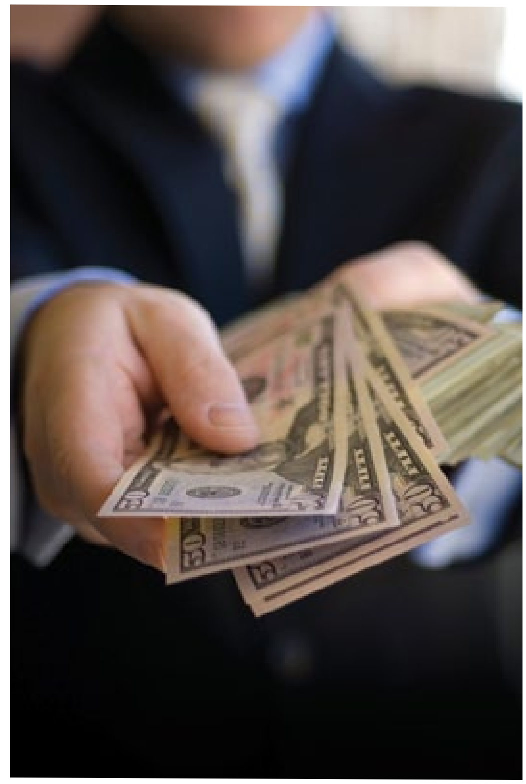
There is also dissatisfaction among the SEC's Commissioners concerning the proposal. For example, Commissioner Luis A. Aguilar issued a statement criticizing the proposal as increasing risk by removing an objective, external determination and creating an opportunity for funds to pursue yield at the expense of investment quality. Although a money market fund's board (or the board's delegate) would be required to make certain investment quality determinations, Commissioner Aguilar is skeptical that any such requirements could adequately offset the risk resulting from eliminating the credit rating requirement. Nor does he believe that any other standard of creditworthiness has been identified that would fulfill that purpose.

Instead, Commissioner Aguilar endorsed a recommendation made last fall by the acting Comptroller of the Currency that Dodd-Frank be amended to permit references to credit ratings to be retained in certain cases, subject to a requirement for additional risk analysis.

Incentive Compensation to Receive SEC Scrutiny

BY ED ZAHAREWICZ

The SEC is proposing to scrutinize incentive compensation arrangements offered by any SEC-registered broker-dealer or investment adviser with at least $1 billion in consolidated assets. Specifically, these firms would fall within the definition of a "covered financial institution" for purposes of rules that the SEC and six other federal regulatory agencies (the Agencies) recently proposed in response to a mandate in the Dodd-Frank Act.


The SEC takes a closer look at incentive proceeds

The proposed rules would:

- Prohibit incentive-based compensation arrangements for executive officers, employees, directors, or principal shareholders ("covered persons") that (a) are so excessive as to expose the covered financial institution to inappropriate risks or (b) encourage inappropriate risks by the covered financial institution that could lead to material financial loss;

- Require covered financial institutions to maintain policies and procedures appropriate to their size, complexity, and use of incentive-based compensation to help ensure compliance with the rules' requirements and prohibitions; and

- Require covered financial institutions annually to provide certain specified information to their appropriate Agencies concerning their incentive-based compensation arrangements for covered persons. This information generally would not be made public, however, and would not include the actual compensation of particular individuals.

In some cases, complying with these requirements could be costly and burdensome; and additional requirements would apply to "larger covered financial institutions," which would include any SEC-registered broker-dealer or investment adviser with consolidated assets of $50 billion or more.

The proposal sets forth general factors for determining whether an incentive compensation arrangement is excessive or otherwise may encourage inappropriate risks. These factors have been adapted from, or are intended to be consistent with, standards and principles for evaluating incentive compensation that have been developed under U.S. banking law and other sources such as the Financial Stability Board. The manner in which the SEC would apply such factors, standards, and principles in particular cases is, however, unclear.

Mark Your Calendars

Richard Choi, Partner in the Washington office, is moderating a panel on SEC initiatives, Tuesday, June 28, 2011 as part of the Insured Retirement Institute's Government, Legal and Regulatory Conference. Visit *www.IRIConferences.org* for more information.

Firms to 'Fess Up to FINRA

BY MARILYN SPONZO

Recently-adopted FINRA Rule 4530 requires, among other things, that a broker-dealer report to FINRA any event that the firm ***has concluded, or reasonably should have concluded,*** was a violation of any foreign or domestic securities, insurance, commodities, financial or investment-related law, regulation or standard of conduct.

Supplementary material accompanying Rule 4530 clarifies that this reporting requirement applies only to violative conduct by the firm or an associated person that has widespread or potentially widespread impact on the firm, customers or markets, or arises from material failure of systems, policies or practices. Additionally, a firm must report multiple instances of violative conduct by any associated person.

FINRA has stated that it will not second guess a firm's "good faith reasonable determination" about whether to report. Nonetheless, many industry observers fear that the benefits of hindsight may cloud FINRA's evaluation of reasonableness in this context.

Particularly difficult issues will arise from the interplay between firms' internal reviews and Rule 4530's self-reporting requirement. In connection with the rule's proposal, FINRA opined that internal audit findings create a strong presumption that a matter is reportable. In promulgating the final rule, however, FINRA Regulatory Notice 11-06 stated that internal review findings do not by themselves lead to the conclusion that a matter is reportable, but are one factor, among others, that a firm should consider in making such determinations.

To address Rule 4530, broker-dealers must develop systems to ensure that:

- Potentially reportable events are evaluated by designated individuals pursuant to a defined escalation process, and the final determination is made by a senior-level principal;

- Documentation of the facts, evaluation and determination concerning each potentially reportable event is maintained;

- Findings from internal audits, office inspections, supervisory control reviews and other internal assessments are included in the evaluation process.

Seeds of an SRO for Independent Investment Advisers

BY TOM LAUERMAN

Some enterprising law students at the University of Mississippi School of Law are launching a Self Regulatory Organization for Independent Investment Advisers (SROIIA). The students are advised by Mercer Bullard, a securities law professor at the school and a well-known investor advocate.

The SEC has submitted a report to Congress advocating an increase in the resources devoted to compliance examinations of investment advisers. To that end, the report recommends that Congress consider (a) authorizing one or more self-regulatory organizations (SROs) to conduct regulatory compliance examinations of investment advisers or (b) providing adequate funding sources for the SEC to expand its own investment adviser examination program.

Many investment advisers strongly oppose the idea of being examined by an SRO, in part because they fear the possibility of becoming subject to FINRA or a FINRA affiliate. Among other things, these advisers see that FINRA continues to regulate broker-dealers with an increasingly heavy hand and fear that FINRA would be even less sympathetic to their own concerns.

The students intend to tailor SROIIA to the specific needs of investment advisers who are not affiliated with any broker-dealer firm. Accordingly, in theory, SROIIA could provide an alternative to FINRA in the event that Congress authorizes an SRO for investment advisers.

As a practical matter, however, the students currently lack the resources to establish a viable SRO, and investment adviser industry organizations have not yet backed any such effort. Nevertheless, if Congress moves toward requiring that investment advisers be subject to an SRO, at least some of the students' work may find a practical application. In the meantime, the students' initiative is garnering considerable publicity and may stimulate additional thought within the investment adviser community concerning the possibility of an SRO of their own.

Dodd-Frank Whistleblower Program Encourages Self-Reporting to the SEC

BY EDDIE KIRTLEY

The SEC's new whistleblower bounty program, mandated by the Dodd-Frank reform legislation, may increase corporate self-reporting of potential legal violations, including violations under the securities laws and the Foreign Corrupt Practices Act.

Under the whistleblower program, any person who provides the SEC with "original information" about a potential violation, which then results in a successful enforcement action with penalties of $1 million or more, is entitled to receive a bounty equal to 10 to 30 percent of the total penalties. However, under an SEC rule proposal, corporate legal and compliance staff, and others who have a duty to investigate and report corporate wrongdoing, generally would be eligible for a bounty only if the company acts in bad faith or fails to self-report the misconduct to the SEC within a "reasonable period."

Accordingly, if a company does not promptly report a potential violation to the SEC, even legal and compliance personnel might be able to earn a bounty, and in many cases the whistleblower's identity could be kept confidential from the company. Rather than vigorously discharging their duties to the company, such individuals might have an economic interest to allow a legal problem to fester and grow, thus maximizing any bounty that they might recover when they later "blow the whistle."

Therefore, **making prompt disclosure of potential violations to the SEC could help companies to defend the integrity of their internal compliance programs**, as well as preserve the potential benefit of any favorable consideration the SEC might afford companies that self-report.

In addition to these potential consequences of the SEC's whistleblower program, FINRA has recently adopted a rule requiring that broker-dealers self-report many violations to FINRA. See "Firms to Fess up to FINRA" on page 14.

Foreign Account Reporting Requirements Clarified

BY KAREN BENSON

In February, FinCEN amended the Bank Secrecy Act regulations that require Reports of Foreign Bank and Financial Accounts (FBARs). U.S. persons (including both individuals and entities) generally must file FBARs if they have "a financial interest in, or signature or other authority over, a bank, securities, or other financial account in a foreign country."

FinCEN's amendments address some of the numerous questions that have arisen about what types of foreign accounts are reportable and who must file FBARs.

For example, the amendments clarify that reportable accounts include, among others, accounts with mutual funds or similar pooled funds that issue shares available to the general public having regular net asset value determinations and regular redemptions. By contrast, FinCEN continues to reserve judgment on whether accounts with privately-offered funds (e.g., hedge funds) should be considered reportable; thus, for now, FBARs need not be filed to report foreign accounts with private funds.

The amendments also relieve officers and employees of certain entities from filing FBARs, notwithstanding that those individuals have signature or other authority over foreign financial accounts owned or maintained by such entities. This relief is available to, among others, officers and employees of financial institutions that are registered with, and examined by, the SEC or CFTC (including mutual funds and broker-dealers), if those individuals do not have a financial interest in the foreign account.

This relief is also available to officers and employees of an "authorized service provider" (such as an investment adviser) that is registered with and examined by the SEC and provide services to an SEC-registered fund. This relief, however, does not extend to reportable accounts maintained by non-fund clients of the adviser. Also, the relief granted to *individuals* does not relieve the entities involved from any obligation they have to file FBARs as to the foreign accounts in question.

Communication From Debt Collector To Consumer's Attorney May Be Actionable Under The FDCPA

BY LARA O'DONNELL GRILLO

The Fair Debt Collection Practices Act (FDCPA) prohibits debt collectors from using "unfair or unconscionable means to collect or attempt to collect debt," including the collection of amounts not "expressly authorized by the agreement creating the debt or permitted by law." In *Allen v. LaSalle Bank*, a consumer filed a class action against the law firm which had previously brought a mortgage foreclosure action against her on behalf of the bank, alleging that letters the bank's law firm sent to her attorney stating amounts at issue violated § 1692f(1) of the FDCPA. Noting a circuit conflict, the New Jersey district court followed the Seventh Circuit's approach that the FDCPA governs communications from a debt collector to a consumer's attorney, but it must be "analyzed from the perspective of a competent attorney" and dismissed the FDCPA claim on the ground that a competent attorney would have recognized the alleged overcharges.

Even letters sent to a consumer's attorney could be out of bounds

The Third Circuit Court of Appeals agreed that the FDCPA governed the communications because "it would undermine the deterrent effect of strict liability" in the statute to allow "an otherwise improper communication" to "escape FDCPA liability **simply because that communication was directed to a consumer's attorney**." The court, however, vacated the judgment and remanded the case for the district court to determine whether the amount sought to be collected "was expressly authorized by the agreement creating the debt or permitted by law." If it was not, then the plaintiff had stated a viable claim under § 1692f(1).

Potential Intraclass Conflict Does Not Defeat Illinois Class Action

BY MICHAEL C. SHUE

In *Mezyk v. U.S. Bank Pension Plan* (Feb. 11, 2011), the U.S. District Court for the Southern District of Illinois certified a class of over 8,000 participants in U.S. Bancorp's pension plan. The lawsuit raised six claims related to the operation of the plan following the enactment of several plan amendments. U.S. Bancorp opposed certification of several claims on the ground that the named plaintiffs were not adequate class representatives. U.S. Bancorp argued that the named plaintiffs sought to void the plan amendments and, therefore, their interests conflicted with those class members who would be worse off if the plan amendments were voided.

Not all potential intraclass conflict is determinative

While the *Mezyk* Court did find that it was hypothetically possible that some putative class members' interests could be opposed to voiding the plan amendments, the Court held that **U.S. Bancorp had not substantiated its intraclass conflict argument because, at the certification hearing, it could not identify any class member who actually opposed voiding the plan amendments**. Prior to granting class certification, the Court also altered the class definition to exclude from the class three individuals – two named plaintiffs and one putative class member – who had raised the same legal issues against U.S. Bancorp in the Eighth Circuit and had lost.

Order Withdrawing Approval of Class Settlement Not Appealable

BY CLIFTON GRUHN

In *McClendon v. City of Albuquerque*, the Tenth Circuit Court of Appeals held that a district court's order withdrawing approval of class action settlements is not a final, appealable order under 28 U.S.C. § 1291 and is not appealable under the collateral order doctrine. The ill-fated appeal arose from the district court's order withdrawing approval of class action settlements after finding that the defendants misrepresented facts that affected the scope of the settlement agreements.

Withdrawal of class settlement approval is not the finish line

The defendants argued to the Tenth Circuit that the district court's order was final because the district court's settlement approval orders were final judgments. The Tenth Circuit disagreed, explaining that "**just because final judgments can be appealed doesn't mean everything in every case that has a final judgment may be appealed.**" The court explained that the district court's order withdrawing approval of the class settlements was akin to orders reopening judgments or granting new trials, neither of which is a final decision under § 1291, because they "settle nothing with finality except the fact that more litigation is on the way." The Tenth Circuit also held that the district court's order did not fall under the collateral order doctrine because "a settlement agreement's promise against future litigation, in whatever form, is insufficient to warrant appeal." The Tenth Circuit concluded that a district court's withdrawal of settlement approval "presses the reset button, vacates any final decision, and marks the case for renewed litigation."

Pre-certification Offer of Judgment Doesn't Moot Class Action

BY SCOTT BYERS

A federal district court in Wisconsin recently found that a putative class defendant could not avoid potential class-wide liability by making an offer of judgment to the plaintiff before the plaintiff moved to certify the class. In *Wilder Chiropractic v. Pizza Hut of Southern Wisconsin*, the class action complaint alleged that the defendant, Pizza Hut, sent unsolicited faxes to more than 3,000 entities in violation of the Telephone Consumer Protection Act. Months before the deadline for class certification, Pizza Hut submitted a Rule 68 offer of judgment to the plaintiff for the maximum recovery permitted under the Act in an attempt to moot the case under the general rule "that a federal court loses jurisdiction over a case when the defendant offers the plaintiff all the relief he could obtain at trial because there is no more relief the court can provide." Plaintiff moved to certify the class on the day Pizza Hut's offer was to expire.

The court found that **since the complaint was filed as a class action, plaintiff was not required to accept the offer because it did not include provisions for the entire class**. The court concluded that it "would make little sense to fashion a rule that would allow the fate of a case to be resolved by a race to the courthouse, particularly when the deadline for filing a motion for class certification is still months away." If the court were to grant the plaintiff's motion to certify the class, it observed, a controversy would still exist.

Did you bring enough for the entire class?

Arbitration Round-Up

BY LANDON CLAYMAN

The Third Circuit Court of Appeals in *Vilches v. Travelers Cos.* addressed the roles of the arbitrator and the court in deciding whether a class arbitration waiver will be enforced. In *Vilches*, the provision requiring arbitration of all employment disputes originally did not mention class action or class arbitration, but reserved to the employer, Travelers, the right to amend the provision at its discretion, with appropriate notice. Subsequently, Travelers electronically communicated a revised arbitration provision that prohibited arbitration through class or collective action. After employees sued Travelers under the Fair Labor Standards Act, the plaintiffs conceded they had agreed to arbitrate such employment disputes, but argued the class action waiver was not binding because they had not assented to its terms and because it was unconscionable and unenforceable.

The district court granted Travelers a summary judgment and ordered the parties to individually arbitrate their claims, holding that the employees had effectively assented to the class action waiver and that it was not unconscionable. The Third Circuit vacated the order, ruling that, because it was undisputed the parties had agreed to arbitrate the FSLA claims, the issue of whether the employees had assented to the class arbitration waiver was not a "question of arbitrability," but rather a question of "what kind of arbitration proceeding" the parties agreed to, and thus was an issue for the arbitrator – not the court - to decide.

The court of appeals then ruled that the issue of whether the class arbitration waiver was unconscionable was a challenge to the validity of the arbitration agreement, and therefore a "question of arbitrability" that was for the court – not the arbitrator – to decide. Assuming for argument's sake that the arbitrator would conclude the employees assented to the class arbitration waiver, the Third Circuit proceeded to hold that the waiver was neither a procedurally nor substantively unconscionable provision. The court referred the matter to arbitration for a determination of whether it could proceed as a class arbitration.

California High Court Sets Precedent for Consumer Class Actions Over Retailers' Collection of ZIP Codes

BY KRISTIN SHEPARD

In its February 10, 2011 decision in *Pineda v. Williams-Sonoma Stores, Inc.*, the California Supreme Court held that requesting and recording a consumer's ZIP Code in connection with a credit card transaction violates California's Song-Beverly Credit Card Act (the Act). In so holding, the court reversed the lower trial and appellate court's findings that a ZIP Code does not constitute "personal identification information" under the Act, as well as disapproved a similar decision by another state appellate court.

The court reasoned that the Act specifies that a consumer's address constitutes "personal identification information." Thus, allowing a retailer to collect a portion of the consumer's address – from which the retailer could, in combination with the cardholder's name, locate the remainder of the address – would "permit retailers to obtain indirectly what they are clearly prohibited from obtaining indirectly, 'end-running' the [Act's] clear purpose." The Act's legislative history reflected that it was designed to preclude retailers from collecting information unnecessary to the credit card transaction, which the retailer could subsequently use for its own marketing purposes.

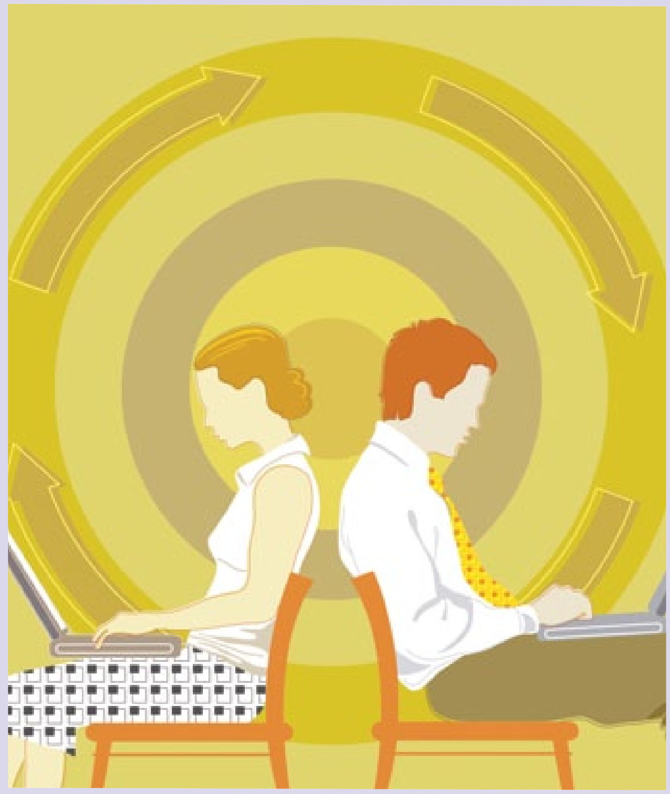
Because copycat putative class actions have arisen in the wake of the ruling, retailers should thus take note of and conform their conduct to the Act's statutory exceptions, which permit collection of "personal identification information" when:

- a credit card is being used as a deposit or for cash advances;
- the entity accepting the card is contractually required to provide the information to complete the transaction or is obligated to record the information under federal law or regulation; or
- when the information is required for a purpose incidental to but related to the transaction, such as for shipping, delivery, servicing, or installation.

Is FTC's "Do Not Track" System Becoming A Reality?

BY JASON MORRIS

On March 16, 2011, the Federal Trade Commission testified before Congress on its efforts in implementing the FTC's proposed Do Not Track system, a mechanism that would allow consumers to choose not to have their internet browsing tracked by third parties. Do Not Track would apply to all companies, including financial institutions, "that collect or use consumer data that can be reasonably linked to a specific consumer, computer, or other device."



The FTC testified that five issues should be considered before developing the system:

1. Do Not Track should be effectuated universally – meaning, consumers should only have to opt out once;
2. The opt-out procedure should be easy to find and use;
3. The consumer's opt-out choice should be persistent (for example, the choice will not be reversed by a consumer deleting their internet cookies);
4. Do Not Track "should be effective and enforceable"; and
5. Do Not Track should let consumers opt-out "for reasons other than commonly accepted uses, such as fraud prevention."

In the same testimony, the FTC urged Congress to enact legislation providing a stronger statutory framework to protect consumers' online privacy. The FTC advised that any such legislation should contain three key provisions:

1. A "consumer privacy bill of rights" to provide baseline consumer data privacy protections;
2. FTC authority to enforce these protections; and
3. Incentives, like safe harbor provisions, for companies to develop and adopt codes of conduct and continued innovation around privacy protections.

The FTC's proposed Do Not Track System was initially discussed in its December 2010 preliminary privacy report, "Protecting Consumer Privacy in an Era of Rapid Change."

Mark Your Calendars

W. Glenn Merten, Partner in the Washington office, will be presenting at the ACLI 2011 Compliance & Legal Sections Annual Meeting, July 11-13 in San Antonio, TX. He will speak on the panel "Arbitration, Dispute Resolution: What is Working?" For more information on the conference, visit *www.acli.com*.

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